

Nonprofit Alert: IRS Issues New Management Contract Safe Harbors for Bond-Financed Property

September 20, 2016

On August 22, the IRS released Revenue Procedure 2016-44, which represents a significant overhaul of the safe harbors under which a management contract will not result in private business use of tax-exempt bond-financed property. This new guidance replaces the safe harbors that were described in Revenue Procedure 97-13 as modified by Revenue Procedure 2001-39 and amplified by IRS Notice 2014-67.

Background

Tax-exempt and governmental organizations often use tax-exempt bond financing for infrastructure spending. While tax-exempt bond financing is beneficial to organizations because it provides low-cost capital, it also involves substantial restrictions because property financed with tax-exempt bonds can only be used in the trade or business of a private person or business to a very limited extent. Therefore, when governmental entities or organizations described in Section 501(c)(3) of the Internal Revenue Code ("qualified users" of bond-financed property) enter into management contracts with professional service providers to manage or use property financed with tax-exempt bonds, they must comply with strict limitations to avoid violating bond covenants.

Previous IRS guidance developed safe harbors to provide qualified users with bright-line rules to avoid too much private business use in management contracts with service providers, but these safe harbor rules were often criticized for not allowing flexibility in business dealings. Revenue Procedure 97-13 required a complicated analysis of the percentages and types of compensation under the contract, with the permitted length of the contract term dependent on the extent to which the compensation was a fixed amount. The new IRS guidance allows for more flexibility in using tax-exempt bonds without exceeding the limits for private business use, and adopts what the IRS refers to as a "more principles-based approach" focused on the qualified user's control over the property, the qualified user bearing the risk of loss, the economic life of a property, and consistency of tax positions taken by the service provider.



Revenue Procedure 2016-44 Safe Harbor Requirements

Under the new guidance, a management contract will not result in private business use if the following requirements are met:

Term of Contract (New)

The term of the contract, including all renewal options, must be no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property—regardless of the type of compensation involved. This represents a significant simplification of the 97-13 safe harbors, which provided for several different allowable contract lengths depending on percentages of fixed and variable compensation.

No Net Profits Arrangements (Not New)

Because the IRS does not want the qualified user to be sharing in profits and losses with a private business, the management contract still must stipulate that compensation cannot be based, in whole or in part, on the net profits from the operation of the bond-financed property, nor must the contract impose on the service provider the burden of bearing any share of net losses from the operation of the managed property. Incentive compensation arrangements (i.e., bonuses) must be based on qualitative measures such as quality of service, performance, or productivity, and not on quantitative measures, such as a share of net profits. In all cases, compensation must be reasonable for the services provided.

Control over the Bond-Financed Property (New)

The qualified user must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget, capital expenditures with respect to the managed property, rates charged for the use of the managed property, and the general nature and type of the use of the managed property (i.e., the type of services).

No Inconsistent Tax Positions by Service Provider (New)

The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. Specifically, the service provider must not behave as if it is an owner of the property for tax purposes—for example, it must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property.

No Circumstances Substantially Limiting Qualified User's Exercise of Rights (Not New)



In general, the service provider must not have a role or relationship with the qualified user that substantially limits the qualified user's ability to exercise its rights under the contract. The new guidance repeats 97-13's requirements in this regard, including that, as a safe harbor, a service provider will not be treated as having a prohibited role or relationship if: (1) no more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in representatives of the service provider; (2) the governing body of the qualified user does not include the CEO (or equivalent) of the service provider; and (3) the CEO of the service provider is not also the CEO of the qualified user or any of the qualified user's related parties.

Clarification Regarding Subordinate Use

In addition to the above safe harbors, Revenue Procedure 2016-44 clarifies that a service provider's use that is "functionally related and subordinate" to its performance under a management contract that meets the safe harbor requirements will not be considered private business use (for example, use of storage areas to store equipment to perform services required under a conforming management contract).

New Guidance, New Questions

Although the new guidance's approach to compensation and contract terms is a welcome simplification, questions remain that may only be clarified over time. For example, the new requirements regarding control over the property and no inconsistent tax positions, described above, appear to require qualified users to incorporate their substance into the terms of the management contract. It is not clear whether a qualified user may meet those requirements *without* incorporating them into the contract, nor is it clear what ongoing obligations qualified users have in these regards.

Application of Revenue Procedure 2016-44

The safe harbors described in the new guidance apply to any management contract that is entered into on or after August 22, 2016, and *may* be applied to any management contract that was entered into before that date. Additionally, the safe harbors described in Revenue Procedure 97-13 and Notice 2014-67 may continue to be applied to contracts entered into before August 18, 2017.